# PERSONAL ASSETS TRUST PLC

## SEPTEMBER 2019 QUARTERLY REPORT N^o. 93

### COULD IT HAPPEN TO US?

Investment funds have been much in the news recently, and not always for the happiest of reasons. Funds in the Woodford stable have been caught up in a nasty portfolio liquidity crunch and this has had a knock-on effect on the firm's listed investment trust, Woodford Patient Capital. Elsewhere, Lindsell Train Investment Trust, long prominent in the sector for its stellar price performance, has run into some unsettling price volatility resulting from questions about the premium to NAV at which its shares sell.

Trusts have also suffered losses from *'torpedo stocks'* within their portfolios. The AIM-listed Burford Capital, which specialises in funding lawsuits in exchange for a portion of the proceeds (and in which both Woodford and Invesco's Edinburgh Investment Trust have significant stakes), fell by 65% in a single day after a hedge fund shorted the stock and justified doing so in a damning research note.

Could such misfortunes happen to us? This Quarterly is a perhaps mundane but nonetheless necessary *'risk audit'* of problems which can face investment funds in general and investment trusts in particular, and which it is the responsibility of the Personal Assets Board, in conjunction with the Investment Adviser, to guard against. My intention is not that of the Fat Boy in *The Pickwick Papers*, *'to make your flesh creep'*, but to stress that the Board's awareness of risk is as high as its tolerance of risk is low.

### RISKS TO WATCH OUT FOR

Managing a fund is more than just managing a portfolio of investments, and very markedly so in the case of an investment trust, which is not only a fund but also a listed company. Some types of risk are common to all or most funds. Others are very rare, but (if they do occur) can cause major problems – for instance, those in a category not otherwise featured here which we might call *Historical Risk*.[1]

The list of risk categories which follows may seem unduly long, but all have at one time or other been raised with me by at least one shareholder or interested investor.

1. Performance Risk.
2. Structural Risk.
3. Gearing Risk.
4. Rating Risk.
5. Regulatory Risk.
6. Supervisory Risk.
7. Management Risk.
8. Policy Change Risk.
9. ESG Risk.
10. Realisation Risk.

### 1. PERFORMANCE RISK

**The Nature of the Risk.** As Maria von Trapp sings to the children in *The Sound of Music*:

*'Let's start at the very beginning,*
*A very good place to start.'*

Every investment fund has performance risk. It is commonly seen as *'risk of underperforming a benchmark'*, but to us it is *'risk of failure to do what it says on the tin'*.

**How We Guard Against It.** We have a clearly-stated policy against which every Board decision and every action the Investment Adviser takes is measured. To quote Kipling's *Kim*, it is our *'ne varietur'* – our guideline and our requirement which will never change.

### 2. STRUCTURAL RISK

**The Nature of the Risk.** Are there aspects of a fund's structure that could hinder performance? Closed-endedness not balanced by a discount and premium control mechanism ("DCM") is the most obvious, but others are gearing, a fixed life, or the existence of other classes of capital. Woodford Equity Income's problem was that under the Open-Ended Investment Company Regulations 2001 it could invest only 10% of its portfolio in unlisteds, and for various reasons (e.g. a fall in net assets while the valuation of the unlisteds remained the same) the fund exceeded this limit.

**How We Guard Against It.** Personal Assets has the simplest possible structure for an investment trust, consisting only of Ordinary shares. It is not geared, has no fixed life, holds no unlisteds, and operates a DCM to ensure that its shares always trade close to NAV.

### 3. GEARING RISK

**The Nature of the Risk.** Gearing is a good servant but a bad master. A reducing pool of assets but the same amount of gearing means that the gearing percentage increases, taking one of the levers of power away from Boards and managers.

**How We Guard Against It.** We have never borrowed money for investment. We were geared in the 1990s, but our geared exposure to markets came from holding investment trust warrants and the shares of investment management companies. It is possible that at some time in the future we may use short-term borrowings, but it is much more likely that we would use equity index futures.

### 4. RATING RISK

**The Nature of the Risk.** This risk is peculiar to closed-ended funds. Personal Assets, while not an open-ended fund in the usual sense, both creates new shares to satisfy demand and buys back shares when demand is exceeded by supply.

[1] Those with long memories may recall how in 1996 Fleming American Investment Trust (now JPMorgan American Investment Trust) had to pay out several million dollars to the US government to pay for the cleaning up of the site of a creosote factory in Louisiana built in 1882 by one of its predecessor companies, the Alabama, New Orleans, Texas and Pacific Junction Railway.

Over the 15 months to 31 July 2019 we issued 305,354 shares for a consideration of £124 million. Had we not done this, a large premium might have emerged. Why, then, don't we just *'let the premium rip'*? Sometimes, too, people talk as if Personal Assets owned an orchard full of low-hanging fruit which the Board inexplicably fails to pick. Why should we not at least be a little greedier and go for one or two extra percentage points on the new shares we issue?

Doing either of these superficially attractive things would in fact break faith with our shareholders. Buyers of new shares are often also existing holders through investment plans. Seeking a bigger increment to NAV through issuing stock at a higher premium would be merely one hand taking from the other. As regards *'letting rip'*, for a short-term benefit you would destroy performance in the long term, there being no way to achieve a decent return if you have a double-figure premium that will naturally trend back to zero — that is, NAV.

**How We Guard Against It.** We ensure that our shares always trade at close to NAV through a combination of share buybacks at a small discount and the issue of new or Treasury shares at a small premium when demand exceeds supply. We are, we believe, unique in the trust sector in that this policy is enshrined in our Articles of Association and could be changed only by a vote by the shareholders themselves in a General Meeting.

### 5. REGULATORY RISK

**The Nature of the Risk.** AIFMD, FATCA, MiFID II – such strings of initials suggest codes waiting to be cracked at Bletchley Park. Some, like FATCA (the US Foreign Account Tax Compliance Act), were imposed from outside, while others, like AIFMD (Alternative Investment Fund Managers Directive), are imposed by the EU.

**How We Guard Against It.** While the AIC does sterling work in this area, it is not to be expected that leaving the EU (assuming we actually do so) will be accompanied by a bonfire of regulations. On the contrary, in the wake of the Woodford problems we would expect regulation to increase. A sizeable slice of every Board meeting will therefore still of necessity be taken up with scrutinising these risks and making sure we're in the clear.

### 6. SUPERVISORY RISK

**The Nature of the Risk.** Is there appropriate oversight of the Investment Manager or Adviser?

**How We Guard Against It.** Independent Boards are one of the greatest advantages possessed by investment trusts. Their job is not to run the trust on a day-to-day and stock-by-stock basis, but, like the sovereign in Bagehot's definition, they have the right *'to be consulted, to encourage and to warn'*, and they know, too, that there are proper occasions for each of these.

Are independent Boards effective? The gentle inquiry, *'Are you quite sure that's a good idea?'* from The Queen would be more chilling than any explosion of rage from President Trump. Quite apart from my rôle at Personal Assets, long experience of the sector has taught me that the same is true of advice behind the scenes from a good Board.

It is the responsibly of the Directors individually and of the Board as a whole to make sure that Personal Assets is run properly, and risk of all kinds has risen higher up the Board's agenda in recent years. Twice a year the Board considers the comprehensive Risk Registers we keep, and these are constantly updated as new risks are identified.

### 7. MANAGEMENT RISK

**The Nature of the Risk.** Fund management is a people business, and as in all people businesses the people concerned don't always do what you want them to. They lose focus, or retire, or move to other firms, and this can cause problems for the funds they leave behind.

**How We Guard Against It.** In 2009 the Board drew up the Investment Advisory agreement to the effect that should the Investment Adviser undergo a change of control or a change in its corporate structure which might reasonably be expected to be materially prejudicial to our interests, or should Sebastian Lyon cease to be a full-time executive of the Investment Adviser, Personal Assets has the right unilaterally to terminate the agreement. Since then, ten years of harmonious working together has done much to produce the Personal Assets we know today, and Sebastian's personal holding of over 15,000 shares shows the strength of his commitment to the trust.

We also make sure that we stick to our knitting and avoid the example of an investment manager whose trust we once invested in. A value investor, he had after initial success been underperforming for years while growth was king. Over lunch one day he told us that he was still a value investor but now needed to be a momentum investor at the same time. We never discovered if he could have pulled off this remarkable feat because we sold the shares that afternoon and the trust itself quietly expired a short while thereafter.

### 8. POLICY CHANGE RISK

**The Nature of the Risk.** This is when a trust either puts proposals to shareholders for a change of investment policy or, on attaining a pre-set winding-up date, produces proposals which don't suit all its shareholders.

Once upon a time (the early 1980s, to be exact) there was a trust which changed its investment policy from being a global generalist to being an industry specialist. In the short term, however, the change was not a success, because of a sudden unforeseen deterioration in the fundamentals of the chosen industry. At the first AGM after the policy change a disgruntled shareholder accordingly scrawled on his voting card the NAV at the year end, the (much higher) NAV at the previous year end and the comment:

*'You must be a shower of bloody idiots.'*

I also once had a personal holding in a trust nearing its winding-up date. The continuation proposals I had expected didn't materialise and I was faced with either a roll-over into a fund I didn't want, or a substantial capital gains tax bill. Only the coincidence of my having capital losses on hand sufficient to offset the gain prevented the wind-up from penalising me financially.

**How We Guard Against It.** *Τα πάντα ῥεῖ, μηδέποτε κατά τ' αυτό μένειν,* as the Greek philosopher

Heraclitus reputedly said – *'all is in flux, nothing stays still'*. Investment styles and specialisations come and go, but capital preservation never goes out of fashion. A trust will usually change its policy in an attempt to improve its rating, but in our case the DCM keeps the share price steady at around NAV. We therefore have no intention of changing our policy, and since we doesn't have a fixed life we never need to have a continuation vote. Just like Personal Assets itself, our investment policy is here to stay.

### 9. ESG RISK

**The Nature of the Risk**. Investors are increasingly conscious of Environmental, Social and Governance ("ESG") risk, which has moved from being a minority interest to its current place in the mainstream of investment decision-making. As the importance of ESG factors has increased in the eyes of regulators and consumers, as well as investors, so the potential financial impact of these factors, both positive and negative, has increased.

**How We Guard Against It.** For Personal Assets' portfolio, the Investment Adviser does not exclude companies from its investment universe purely on ESG grounds. Rather, analysis of environmental, social and governance risks is integrated into the research and decision-making process. This entails consideration of both the negative risks and the opportunities for companies that are on the front foot as regards these issues. Engagement with the management teams and boards of the companies we own continues to be a critical part of the Adviser's investment process. The Adviser votes all proxies of shares owned and engages with management teams on material issues. It is essential that we keep abreast of how this landscape is evolving and the Board will continue to require that the Adviser provides updates on how ESG is integrated in response to the changing nature of the risks.

### 10. REALISATION RISK

**The Nature of the Risk.** The Woodford affair has reminded us that this is one of the gravest risks facing investment funds. Is there a danger that the managers will have to disturb investments before they have had the chance to mature, in order to repay departing investors or meet other demands for cash? The first forced asset sale on record is in the Bible (Genesis 25, 28-34), where Esau, faint from lack of food, found himself having to sell his birthright for a mess of pottage – a famously poor bargain which acts as a warning for all generations to come when assets have to be disturbed prematurely for cash.

It was as long ago as March 1995, in Quarterly N°. 3, that I described Thomas Mann's great novel *Buddenbrooks* as an investment classic. It chronicles the rise and fall of a merchant house in the north German city of Lübeck, and how Senator Thomas Buddenbrook, the third of his line, failed disastrously as he tried to live up to the example of his father and grandfather. What I didn't mention then was how the story ends, with the forced sale of the business for well below its true value – a reminder of how serious and sad 'realisation risk' can be.

*'The liquidation of the business . . . took a most deplorable course . . . The pending business was disposed of on hurried and unfavourable terms. One precipitate and disadvantageous sale followed another . . . and so the losses piled up. Thomas Buddenbrook had left, on paper, an estate of* [650,000] *marks. A year after the will was opened it had become . . . clear that there was no question of such a sum.'*

The last straw was when the family house was sold for a disappointing amount and replaced by a small villa for which Thomas Buddenbrook's executors paid too high a price. Those who believe house property is a one-way bet should read *Buddenbrooks* and weep.

**How We Guard Against It.** Losses through realisation risk can be severe. They would, however. be much less of a danger for Personal Assets because our equity portfolio is made up of the bluest of blue chips. While these are not impervious to large swings in value such as BAT experienced in 2018, if the likes of Microsoft or Unilever were, like Burford Capital, to fall by 65% in a day it would surely be Armageddon and we would have more to worry about than Personal Assets' share price. In his presentation at the Annual General Meeting, Sebastian tellingly demonstrated how in normal circumstances 95% by value of Personal Assets' shareholders' funds could be realised within a single day. Even in abnormal markets Personal Assets would be better placed than many trusts in terms of liquidity.

### DOES SIZE MATTER?

The wealth managers Charles Stanley recently wrote of Terry Smith's Fundsmith Equity:

*'To us, a developing issue is the size of the fund, which we believe may, at some point, become more of a challenge for the manager. At around £19 billion it is the largest UK retail fund and it continues to attract substantial inflows from investors. As a fund grows in size it can sometimes mean the loss of flexibility in terms of the number of available investments.'*

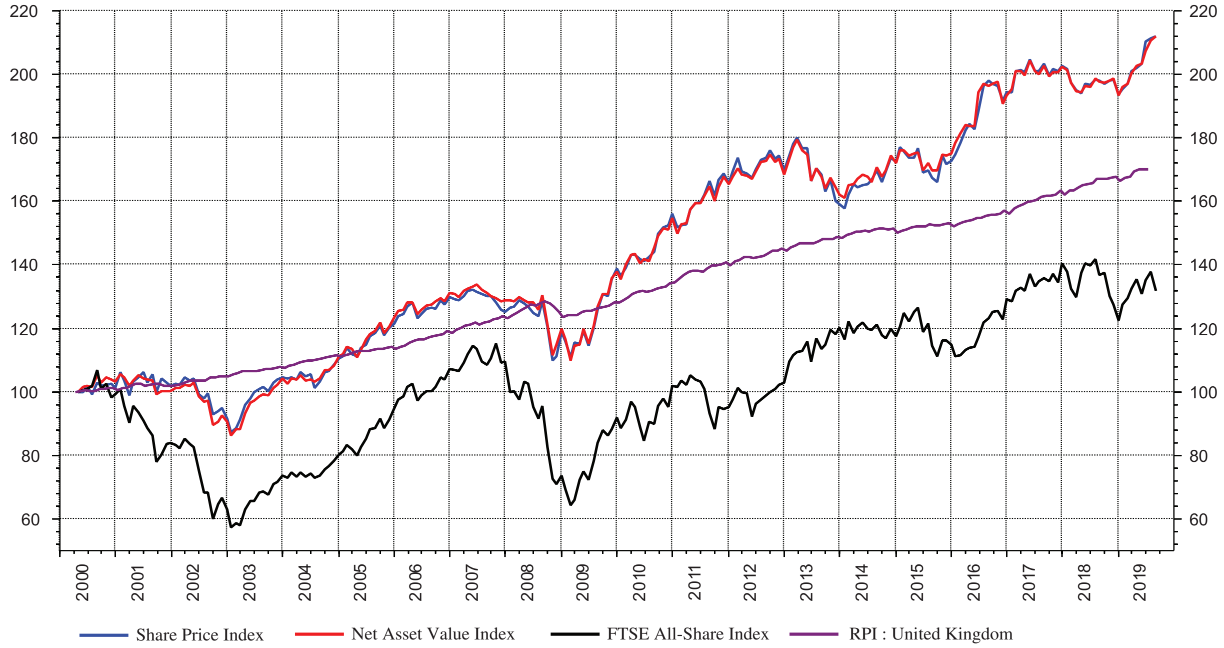
When Ian Rushbrook became Investment Director of Personal Assets in 1990, our shareholders' funds stood at £8.6 million. As I write, they are £1.1 billion. What difference has this made to our investment process, and are there any hidden dangers?

It is obviously more difficult for a small shareholding (or a holding of a small stock) to make a difference to the total. Small stocks are not, therefore, natural holdings for Personal Assets. In the 1980s we did for a while invest in small companies and unlisteds, but in the early 1990s Ian Rushbrook correctly determined that the time had come to switch into larger stocks.

What we do nowadays is not much affected by our size. Had we been a specialist fund investing in small companies or unlisteds, the inflows and outflows of money we've experienced over the years would surely have been disastrous. But today our exposure is almost entirely to large stocks and the average market capitalisation of our equity holdings is £184 billion. Whether we fell to £100 million or rose to £10 billion we could hold broadly the same portfolio. We are simple, basic and boring, not seekers after undiscovered gems. We look for undervaluation, for good intrinsic value, and for companies which (like Personal Assets itself) put their shareholders first.

**ROBIN ANGUS**

## Personal Assets Trust Performance




Source: Refinitiv Datastream

| **Value** | **Percentage Changes 31 Aug 2019** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **30 Apr 2000** |
|---|---|---|---|---|---|---|
| Share Price | £428.50 | 7.1 | 7.1 | 24.9 | 68.4 | 112.1 |
| NAV per Share | £423.49 | 7.3 | 7.9 | 24.2 | 67.0 | 112.0 |
| UK RPI | 289.50 | 1.9 | 9.5 | 12.6 | 35.0 | 70.2 |
| FTSE All-Share Index ("Index") | 3,953.02 | (3.7) | 6.9 | 8.6 | 56.8 | 31.7 |
| NAV relative to Index | | 11.4 | 0.9 | 14.4 | 6.5 | 61.0 |

**Past performance is not a guide to future performance.** The value of investments may go down as well as up and you may not get back the full amount originally invested.

## Top 10 Equity Holdings

| **Company** | **Country** | **Sector** | **Valuation 31 Aug 2019 £'000** | **Shareholders' funds %** |
|---|---|---|---|---|
| Microsoft | USA | Technology | 48,216 | 4.4 |
| Nestlé | Switzerland | Food Producer | 36,622 | 3.4 |
| Coca-Cola | USA | Beverages | 32,646 | 3.0 |
| Unilever | UK | Food Producer | 32,592 | 3.0 |
| British American Tobacco | UK | Tobacco | 26,819 | 2.5 |
| Philip Morris | USA | Tobacco | 23,692 | 2.2 |
| American Express | USA | Financial Services | 21,768 | 2.0 |
| Berkshire Hathaway | USA | Insurance | 21,340 | 2.0 |
| Procter & Gamble | USA | Household Products | 20,407 | 1.9 |
| Alphabet 'A' | USA | Technology | 16,680 | 1.5 |
| | | | **280,782** | **25.9** |

## Portfolio Analysis

| | **Valuation 31 Aug 2019 £'000** | **Shareholders' funds %** |
|---|---|---|
| Equities | 372,663 | 34.0 |
| US TIPS | 360,586 | 33.0 |
| UK T-Bills | 190,355 | 17.4 |
| Gold Bullion | 100,725 | 9.2 |
| US Treasuries | 39,954 | 3.6 |
| UK Index-Linked Gilts | 33,442 | 3.1 |
| Cash and Cash equivalents | (5,565) | (0.4) |
| Property | 1,660 | 0.1 |
| **Shareholders' funds** | **1,093,820** | **100.0** |

Further information on the Trust can be obtained from the Company's website – www.patplc.co.uk or by contacting Steven Budge on 0131 538 6605.